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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner

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Commissioner

Arizona Corporation Commission
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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASE IN ITS RATES AND CHARGES BASED THEREON

DOCKET NO. W-02113A-13-0118

CHAPARRAL CITY WATER COMPANY'S REPLY BRIEF

A. INTRODUCTION

Through this filing, Chaparral City Water Company ("CCWC" or "Company") responds to the Opening Briefs filed by both the Arizona Corporation Commission Staff ("Staff") and the Residential Utilities Consumer Office ("RUCO"). Those briefs highlight the disputes still in existence between the parties as well as the punitive and unsupported nature of certain of the key positions taken by both Staff and RUCO. The determination of these key issues, especially the unwarranted use of a hypothetical capital structure without notice for a recently purchased utility, will send an important message as to whether the Commission wants to continue to attract and support investment in Arizona utilities by responsible water providers such as EPCOR. If it does, certain of the positions taken by Staff and RUCO in this proceeding must be discouraged and rejected.

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B. ADDITIONAL BACKGROUND

As noted in the Company's Opening Brief, this rate case must be viewed with particular attention to the context in which it arose. In 2011, EPCOR Water (USA), Inc. ("EPCOR") purchased CCWC from American States.[1] Shortly before the closing of that acquisition, the Commission had entered its decision in CCWC's prior rate case.[2] In that case, the Commission, using CCWC's actual capital structure, approved a rate increase for CCWC.[3]

Since the test year in the last rate case, CCWC has invested more than $15,000,000,[4] with much of that occurring under EPCOR's ownership.[5] Although RUCO seems to question this investment in its briefs, it is uncontroverted in this case that these recent investments by CCWC were prudent and that EPCOR, as a responsible owner of CCWC, has ensured compliance with Commission orders, rules and regulations and has continued to provide safe and reliable drinking water to CCWC's customers.[6] Rather than recognize the appropriate nature of CCWC's actions, Staff and RUCO continue to recommend certain results-based regulation in the form of a hypothetical capital structure and "modified" vintage depreciation method. As evidenced by their briefs, these newfound approaches to these two critical issues were developed without detailed analysis and without merit.[7] These two issues accounts for the bulk of the difference in the parties' recommended revenue increase.

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[1] Exhibit ("Ex.") A-3 at 2-4; Decision No. 72259.
[2] Ex. A-13 (Decision No. 71308).
[3] *Id.*
[4] Ex. A-3 at 7.
[5] Ex. A-17 at 12; Ex. A-3 at 10.
[6] Ex. A-3 at 10; Ex. S-6 at Ex. KS at 11-12; *see also* MCESD Compliance Status Report attached to Company's Application (Ex. A-1).
[7] RUCO argues in its Opening Brief that "[t]he Commission should stick with the proven and traditional ways of ratemaking." RUCO's Opening Brief at 2. Of course, this argument contradicts RUCO's own position on the key issues of capital structure and depreciation methodology.

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C. COST OF CAPITAL

1. Hypothetical Capital Structure

Staff and RUCO continue to recommend the use of a hypothetical capital structure.[8] As the uncontroverted testimony has shown, the effect of such a hypothetical capital structure is an effective return on equity ("ROE") recommendation of 7.67%,[9] which results in an approximately 200 basis point financial risk adjustment to the ROE.[10] The use of a hypothetical capital structure is contrary to Staff's approach in all recent cases for water utilities with similar capital structures or even capital structures with one hundred percent equity.[11] In those cases, although Staff has often recommended a financial risk adjustment, it has always recommended the use of the companies' actual capital structure.[12] Mr. Cassidy admitted that this case was the first time in his tenure at the Commission that he had made such a hypothetical capital structure recommendation.[13] What is most shocking is that this recommendation was done without any analysis as to the impact of this new approach versus Staff's traditional approach (*i.e.,* the use of the actual structure).[14] On cross-examination, Mr. Cassidy conceded that he did not undertake any analysis to examine the impact of the use of the hypothetical capital structure versus the use of Staff's standard adjustments.[15] Rather, he testified that he recommended this major change in approach because it was "suggested" by another Staff member, presumably a supervisor, that he make this adjustment in lieu of another type of financial risk adjustment.[16]

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[8] The WUAA, as a representative of the water utility industry, argues against the use of the hypothetical capital structure as bad public policy. As explained by the WUAA, this will make it even more difficult for CCWC to earn a reasonable return. As demonstrated in the Company's Schedules filed with its Application, the Company's actual returns have not exceed 5.33% since the last rate case. WUAA Opening Brief at 2.
[9] Ex. A-12 at 10.
[10] *Id.*
[11] Tr. at 400-412; *see, e.g.,* Decision No. 74294 at 46.
[12] *See, e.g.*, Decision No. 73996 at 29; Decision No. 74097 (using an upward financial risk adjustment).
[13] Tr. at 400.
[14] Tr. at 388.
[15] *Id.*
[16] *Id.*

Despite the lack of any notice to CCWC (or EPCOR) that it should move to a different capital structure, Staff argues ironically that "there is an issue of fairness in this situation in that CCWC's capital structure is radically different than that of its fellow subsidiaries."[17] Remarkably, Staff also agrees with RUCO that the Company should have been on notice based on Mr. Parcell's testimony in the prior rate case that "a case can be made that CCWC's capital structure should be that of its consolidated parent."[18] This, of course, ignores that the Commission neither considered nor adopted any hypothetical capital structure in the prior case. Nor did the Commission, Staff or RUCO raise any issues with the Company's capital structure in the docket in which the Commission approved EPCOR's purchase of CCWC with its existing capital structure. The true issue of fairness, of course, is the proposal to "flash cut" to an imposed capital structure without notice and without providing the Company time to implement any plan by which the Company could move to a different capital structure.

As noted above, Staff, in all recent dockets prior to this rate case, continued to recommend the use of the actual capital structure for purposes of setting rates.[19] In addition, when CCWC filed to refinance its existing debt with debt for which it would not pay down the principal (which would have the effect of maintaining the debt to equity percentages), Staff rejected that approach in favor of a standard mortgage type financing that will have the effect, all things equal, of increasing the proportion of equity.[20] These signals all indicate a preference for the use of the Company's actual structure and an aversion to any requirement that CCWC change its capital structure. Yet, despite these signals, Staff continues to recommend in favor of the hypothetical structure to "encourage" the Company to balance its capital structure.[21] As noted by the

[17] Staff's Opening Brief at 26.
[18] *Id.* at 25-26.
[19] Ex. A-12 at 10; Tr. at 400-412.
[20] Decision at 74388; Tr. at 433-34.
[21] Tr. at 431; Staff's Opening Brief at 25.

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Company in its Opening Brief, when the Commission has desired to "encourage" such a change, it has historically required the utility to put forth a plan to do so or to make a commitment to do so prior to its next rate case.[22] This approach makes sense, as it is not sensible or practical for a utility to change its capital structure overnight.[23]

Neither Staff nor RUCO did any analysis as to how CCWC could or should move to a different capital structure. In Mr. Parcell's view, "the Company can do whatever it wants."[24] However, not only is that response untrue, it is disingenuous and again highlights the irresponsible results-based nature of this hypothetical capital structure recommendation by both Staff and RUCO.

a. The Reliance on the Double Leverage Argument Has No Basis or Relevance

In apparent recognition that its citation to double leverage has no basis, Staff makes no reference to double leverage in its Opening Brief. RUCO, however, in an apparent attempt to bolster its late support of the double leverage argument, does cite to Staff's reliance on this flawed concept.[25] Simply stating that there is double leverage does not make it so. As Ms. Ahern explained in her testimony, a cursory review of the Company's financials, which the parties had as part of discovery, would have made this clear.[26] Instead, Staff simply viewed the capital structures of CCWC's affiliates and concluded that double leverage must exist: "Staff considers these variances in capital structure between CCWC and both its ultimate and immediate parent to be *prima facie* evidence that double leverage is present."[27] Of course, Ms. Ahern's testimony makes

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[22] Decision No. 68310 at 9, 15; Tr. at 407.
[23] As the Company noted in its Opening Brief, there are legal limits on dividends, and the Commission has often looked very closely at large dividend issuances. There are also timing issues and approval requirements for new debt issuances. *See* Company Opening Brief at 6.
[24] Tr. at 347.
[25] RUCO Opening Brief at 22.
[26] Ex. A-12 at 5-6.
[27] Ex. S-3 at 4. Interestingly, there was no concern about the possibility of double leverage when CCWC was owned by American States, another entity with multiple affiliates.

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clear that it could not exist, which shows the double leverage argument cannot be used as support for the hypothetical capital structure recommended by Staff.

b. RUCO's Support of the Hypothetical Capital Structure Continues to Be Without Merit.

RUCO's support of the hypothetical capital structure continues to be without merit. Mr. Parcell recommended the use of CCWC's actual capital structure as a Staff expert in the Company's prior rate case.[28] Then, when given the chance to re-examine the issue as RUCO's witness in this case, he again recommended the use of the Company's actual capital structure in his direct testimony.[29] Although Mr. Parcell testified at the hearing that he changed his position because he had "seen the light", it continues to be beyond reason to believe that Mr. Parcell's "expert" opinion changed from 8.7% on December 9, 2013 to 7.98% on February 7, 2014, when he admitted that he made no other adjustments during that time, but simply adopted Staff's hypothetical capital structure.[30] This type of results-based regulation must be discouraged.

2. Cost of Equity

a. The Commission Should Adopt a Cost of Equity of 10.5 Percent.

Rather than support the recommendations made by Mr. Cassidy regarding cost of equity, Staff attempts to discredit Ms. Ahern's recommended ROE. However, Staff's arguments fail to provide any support for a reduction to the recommendation made by the Company's expert. Staff provides no evidence or argument to discredit the modeling done by Ms. Ahern. Rather, Staff attacks Ms. Ahern's risk adjustments. According to Staff, the effect of the Company's small size "would be reflected in the Company's beta."[31] However, the Company has no beta that would reflect its size, so this argument

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[28] Ex. R-9.
[29] Ex. R-7 at 15-16.
[30] Ex. R-7; Ex. R-8; Tr. at 327-28.
[31] Staff's Opening Brief at 26.

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is without merit. Staff continues by arguing inconsistently that these risks are not systematic but rather "firm specific".[32] If that is indeed the case, then there would be no reflection of the risk in the Company's beta, as beta does not measure firm specific risk. As Ms. Ahern testified, a proper analysis looks at what would occur if the Company were spun off and publicly traded tomorrow (*i.e.,* would its cost of equity be any different than today?).[33] If that were the case, CCWC's capital structure and operating characteristics would not change and neither would its business and financial risk, as reflected in Ms. Ahern's calculations. Thus, the adjustments made by Ms. Ahern are appropriate and should be adopted.[34]

Unlike Staff, which, contrary to the Efficient Market Hypothesis ("EMH"), relied upon only one model, Ms. Ahern relied upon the application of market-based cost of common equity models, including the Discounted Cash Flow ("DCF") model, the Risk Premium Model ("RPM") and the Capital Asset Pricing Model ("CAPM"), to the market data of the proxy group of nine water companies.[35] Her findings, which were based on this extensive analysis as explained in the Company's Opening Brief, are summarized below: [36]

	Proxy Group
Discounted Cash Flow Model	8.24%
Risk Premium Model	11.44%
Capital Asset Pricing Model	9.77%
Indicated Common Equity Cost Rate (before Adjustments)	9.80%
Credit Risk Adjustment	0.32%
Business Risk Adjustment	0.40%
Indicated Common Equity Cost Rate	10.52%

[32] Furthermore, it is naïve to argue that investors do not account for firm specific risk.
[33] Ex. A-10 at 44-45; Tr. at 252.
[34] Staff also argues that the failure of the Commission to adopt this small firm adjustment in recent cases is also an impediment to its adoption here. The same, of course, is true of its hypothetical capital structure.
[35] Ex. A-10 at 25-42.
[36] *Id.*

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Recommended Common Equity Cost Rate (rounded) 10.50%

These conclusions are supported by the weight of the evidence in Ms. Ahern's testimony and should be adopted by the Commission.

b. RUCO's Cost of Equity Recommendation Is Not Reasonable

Mr. Parcell recommends a cost of equity of 9.35%.[37] Unlike Mr. Cassidy and Ms. Ahern, who both updated their recommendations during the proceeding, Mr. Parcell made no adjustments to his cost of equity recommendation between the time of his direct testimony and the time of rebuttal testimony—except one major adjustment, which was the unsupported adoption of Staff's hypothetical capital structure.[38] Although Mr. Cassidy recognized a need to increase his cost of equity recommendation by 30 basis points during that time based on his analysis using the DCF model, Mr. Parcell undertook no additional analysis and made no other adjustments.[39]

In addition, Mr. Parcell's application of the CAPM is flawed in several respects and should not be relied upon.[40] As Ms. Ahern testified, Mr. Parcell incorrectly relies upon an *historical* risk-free rate even though ratemaking and the cost of capital are prospective.[41] He also incorrectly calculates his market equity risk premium by relying upon (i) the actually achieved, or non-market based, rates of return on book common equity for the S&P 500; (ii) a geometric mean historical market equity risk premium; and (iii) the historical total return on U.S. Treasury securities.[42] Furthermore, Mr. Parcell fails to employ a prospective equity risk premium.[43] Finally, Mr. Parcell also fails to utilize any upward credit risk or business risk adjustments even though the evidence

[37] Ex. R-7; Ex. R-8.
[38] Tr. at 327.
[39] *Id.*; Ex. S-3.
[40] Ex. A-11 at 37-48.
[41] *Id.* at 39-40.
[42] *Id.* at 40-46.
[43] *Id.* at 46.

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supports such adjustments due to CCWC's small size and likely bond rating.[44] When these adjustments are properly included, and when the CAPM analysis is properly applied, the result is a 10.59% ROE, which is in line with the Company's requested 10.50% ROE.[45]

RUCO attempts to discredit Ms. Ahern's testimony in its Opening Brief. First, RUCO argues that Ms. Ahern is incorrect in her assessment of the DCF model's results. According to RUCO, "[i]f investors believe that markets are efficient, there is no reason to modify either the stock prices or market models that stock prices are based on."[46] However, RUCO's arguments are misplaced. The Company has not recommended any modification of either stock prices or market models. Stock prices are not based upon market models as implied from RUCO's argument; rather, they are based upon investors' expectations of risk.[47] And, although RUCO claims that the Efficient Market Hypothesis is inconsistent with Ms. Ahern's argument that the DCF model's results are understated, RUCO misstates Ms. Ahern's argument.[48] Her argument, when properly reviewed, is that the DCF model produces understated results when applied to a book value rate base and when market to book ratios are above one.[49]

RUCO also argues that Ms. Ahern selectively chooses a starting point to argue that risk premiums have increased.[50] Quite to the contrary, however, Ms. Ahern selected this starting point as it was the date of the decision in the Company's last rate case.[51] As such, given the increasing risk premiums from that date forward, and the finding of a

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[44] *Id.* at 60-61.
[45] *Id.* at 50, 60-62.
[46] RUCO's Opening Brief at 23.
[47] Tr. at 303.
[48] RUCO's Opening Brief at 23.
[49] Ex. A-11 at 15-16; 20.
[50] RUCO's Opening Brief at 24.
[51] Ex. A-11 at 50-51.

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cost of equity of 9.90% in that case, it is not proper to adopt a lower cost of equity in this case.[52]

Finally, RUCO claims that the exclusion of utilities from the Company's comparable earnings analysis is inappropriate.[53] Despite RUCO's argument to the contrary, *Hope* and *Bluefield* do not require the use of utilities for a comparable earnings analysis. Rather, those cases require an analysis of firms having "corresponding risks" without mention of the type of firm.[54] Utilities compete for capital with all types of firms, not just other utilities. In addition, as explained by Ms. Ahern, allowing utility ROEs to determine other utilities' ROEs is circular and will lead to upward or downward spiraling ROEs depending on the current trend.[55]

D. RATE BASE/REVENUE REQUIREMENT

1. Post Test Year Plant

The Company and Staff have recommended identical net plant in service amounts, which in part results from Staff and the Company agreeing on the amount of post-test year plant.[56] The uncontroverted evidence in this case is that all of the post-test year plant is in service and used and useful. As part of his sworn testimony, Mr. Stuck confirmed that all of this plant is in service.[57] There is no evidence in the record to find otherwise. RUCO, during the hearing, confirmed that it had no dispute with the invoices provided by the Company.[58] Yet, RUCO continues to dispute the post-test year plant put into service after June 30, 2013 and certain recurring projects occurring prior to that date. There is no basis to exclude the recurring projects, as they are used and useful and properly included in rate base. Based on its testimony, RUCO would have taken no issue

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[52] Decision No. 71308.
[53] RUCO's Opening Brief at 24.
[54] *Bluefield Water Works & Improvement Co. v. Pub. Ser. Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923); *Fed'l Power Comm'n v. Hope National Gas Co.*, 320 U.S. 591, 603 (1942).
[55] Ex. A-11 at 58.
[56] Company's Schedules; Staff's Schedules.
[57] Ex. A-19.
[58] Tr. at 691-92.

with the projects occurring after June 30, 2013 if the Company had rushed them into service prior to RUCO's six month deadline.[59] This, of course, is quite contrary to the tone of RUCO's other arguments in relation to the SIB requests in which RUCO argues that the Company should wait to put in needed plant.

RUCO also argues that Staff should have conducted a field inspection for this additional plant. RUCO, of course, made no inspection itself, nor did it question any of these amounts prior to the hearing (other than its arbitrary six month deadline). However, as Ms. Stukov correctly noted during the hearing, much of this plant is underground, and a field inspection would not have provided any means to audit that the plant is in service.[60] For example, much of the additional plant put in service after the August 2013 field inspection involved service lines, valves, mains and other distribution infrastructure, all of which are underground.[61] It is also difficult to audit meters and hydrants, which account for additional post-test year amounts.[62] Although Staff did not conduct an additional field inspection after August 2013, it did review all of the Company's additional expenditures (as did RUCO) and confirmed that the amounts requested by the Company were appropriate.[63]

For these reasons, it is appropriate for the Commission to include the amounts requested by the Company for post-test year plant.

2. 24-Month Deferral of Depreciation and AFUDC

Depreciation, unless recovered in rates, immediately begins to drain a utility's earnings, resulting in reduced returns on equity.[64] The inability to recover the return and the associated depreciation when new plant is put into service until a new rate decision is

[59] Tr. at 689-90.
[60] Tr. at 573.
[61] Ex. A-19 at 7-8.
[62] *Id.*
[63] Staff's Schedules.
[64] Ex. A-6 at 13.

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issued has long been referred to as "regulatory lag."[65] In its Opening Brief, Staff continues to distance itself from its own recommendation.[66] The Company recognizes and appreciates that approval of the SIB mechanism would address one aspect of regulatory lag. However, the SIB mechanism and this 24-month deferral mechanism are not mutually exclusive. In this case, given the timing of the request, it is impossible for there to be any double counting (*i.e.*, inclusion of amounts requested in the deferral as part of a SIB request).[67] The Company recognizes and agrees that plant included in a SIB request could not be included in a future deferral request. It is not difficult for these to be segregated, and this should in no way serve as an impediment to approving these types of deferral requests.

Although both Commission Staff and RUCO have rejected CCWC's request for this deferral mechanism, they do so based upon a faulty premise and attempt to make the Company's request sound illogical.[68] This deferral request would be unnecessary if rates could be adjusted to provide a return on investment in a shorter period of time than is now the case.[69] However, that is not the practical reality of ratemaking in Arizona given the use of the historic test year. This deferral mechanism is a sound method to deal with AFUDC on actual additions to plant and actual depreciation expenses that occur prior to new rates going into effect. In this case, CCWC has made a very reasonable request in the amount of $473,463 to reflect AFUDC and depreciation expenses for that 24-month period and the Company requests that it be adopted in this case.[70]

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[65] *Id.* at 13-14.

[66] This recommendation was one of two made by Commission Staff in its Report to address regulatory lag. These recommendations were made after multiple workshops and industry participation. Ex. A-33. Given the amount of work and analysis that went into that process, it is disappointing and surprising to have Staff not support its own recommendation.

[67] Ex. A-6 at 14-15.

[68] Ex. S-8 at 16; Ex. R-13 at 19-23; Ex. A-6 at 14.

[69] Ex. A-6 at 14

[70] Ex. A-2 at Sch. B-2 at 6.

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3. CAP Deferral

CCWC is seeking, and Staff is recommending, the inclusion of the amounts deferred pursuant to the decision in its prior rate case related to CAP M&I costs.[71] In that prior case, the Commission found CCWC's purchase of the additional CAP allocation to be a prudent expenditure but deferred fifty percent of M&I capital costs for consideration in this matter.[72] In its Opening Brief, RUCO continues to argue against the inclusion of these amounts.[73] Commission Staff, in recognition of the critical, renewable resources, supports CCWC's request in this case to begin recovering the deferred and ongoing CAP M&I capital expense.[74]

RUCO continues to question the amount of the additional allocation that is needed and used and useful.[75] The Commission determined in the Company's last rate case that the purchase of the allocation was a prudent investment that provided CCWC's "customers continued access to adequate renewable water supplies."[76] That issue is not in dispute. As a result, now is the appropriate time to include the properly deferred amounts in rate base. As Mr. Lenderking explained in great detail, it is not prudent for a water utility to have only enough water supply to meet the needs of its customers in only a single year.[77] Customer demand is variable.[78] In fact, in CCWC's territory, customer demand has changed by as much as 22.5% in just two years.[79] As the Commission recognized in the last rate case, the size of the allocation available to CCWC, as recommended by ADWR and approved by the United States Department of the Interior, was a set amount *(i.e.*, 1931 acre feet).[80] CCWC was not given the option to purchase

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[71] Decision No. 71308 at 25.
[72] Decision No. 71308 (Ex. A-13); Ex. A-25 at 2.
[73] RUCO's Opening Brief at 5-6.
[74] Staff's Schedules.
[75] Ex. R-13 at 12-18; RUCO's Opening Brief at 5-6.
[76] Decision No. 71308 at 16, 67.
[77] Ex. A-25 at 2-9; Ex. A-26 at 1-2.
[78] Ex. A-26 at 1-2.
[79] *Id.*
[80] Ex. A-26 at 5-7.

any amount that it desired, and it was made clear at the time that this allocation would not likely be available again.[81]

Just as it is prudent for CCWC to have purchased this additional allocation, it is also prudent and sound public policy for the Commission to allow CCWC to recover the costs associated with that prudently purchased allocation. RUCO, as it has argued with regard to numerous issues, wishes for the Company to continue to defer these costs and recover them at a later date. However, these costs have already been deferred for 60 months without any payment by customers.[82] This was a prudent purchase by the Company, and customers should be given appropriate price signals as to the true cost to provide water service in CCWC's territory.

4. Cash Working Capital

The inappropriate nature of the use of a hypothetical capital structure is highlighted in the cash working capital calculation.[83] Both Staff and RUCO continue to support the use of a hypothetical interest expense based on their recommended hypothetical debt.[84] The use of hypothetical interest expense has the effect of reducing income tax expense by overstating the interest deduction which in turn understates the effect of income tax expense on cash working capital.[85] Although any hypothetical capital structure should be rejected for the reasons noted above, the improper implications of such use for purposes of cash working capital provides another basis by which to reject the hypothetical capital structure.

In addition to using a hypothetical interest expense, both Staff and RUCO also argue that regulatory expense should be excluded from the calculation of cash working

[81] *Id.*
[82] RUCO also takes issue with the 60-month period. As noted by the Company, EPCOR did not file a rate case until it had ownership of CCWC for one year so that it would better understand the system. Ex. A-3 at 2. This, of course, postponed any rate increase, which benefits customers.
[83] Tr. at 824-826; Ex. A-6 at 17-18; Tr. at 69-70.
[84] RUCO's Schedules; Staff Opening Brief at 4.
[85] Ex. A-6 at 19.

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capital.[86] Regulatory expense is the expense incurred by the Company to prepare and litigate rate proceedings before the Commission and consists of cash expenditures to cover this expense.[87] As Ms. Hubbard explained in her testimony, this item of cash working capital has traditionally been included in the cash working capital calculation for CCWC's affiliates.[88] It is amortized over a period of years and, accordingly, should be included in the calculation of cash working capital just as any other recurring expense. The exclusion of this amount results in an unsupported understatement of cash working capital, which is unfair to the Company and should be rejected.[89]

For purposes of computing the customer accounting expense, the bad debt expense that arises due to the authorized increase in revenue is added to the adjusted test year level of customer accounting expense in the cash working capital calculation.[90] Although Staff corrected this item, RUCO continues to inappropriately exclude this additional customer accounting-related expense arguing that it is a non-cash expense (*i.e.*, the Company does not make a payment for bad debt).[91] This argument misses the point. Bad debt, as a loss of revenue, clearly impacts the Company's cash working capital and must be included in the calculation.[92] This is an adjustment that is traditionally made by the Commission and there is no basis for its exclusion here.[93]

RUCO and Staff also continue to argue about the amounts related to the IDA bonds. The Company, as it promised to do, removed the amount of the IDA bank balance from its calculation of working capital in its Final Schedules.[94] The Company

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[86] RUCO's Opening Brief at 8; Staff's Opening Brief at 3.
[87] Ex. A-6 at 19.
[88] *Id.*
[89] *Id.*
[90] *Id.* at 21-22.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] Company Schedules (B Schedules).

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has also removed the amount for the audit related to the IDA bonds from the calculation.[95]

E. Operating Income Issues

1. Depreciation Expense

As Staff notes in its Opening Brief, the amount of depreciation expense in the parties' Final Schedules is extremely close.[96] Despite this, or perhaps because of this, the most surprising and unsupported change in policy in this case is Staff's (and ultimately RUCO's) recommended change in methodology for depreciation. Although Staff refers to this approach as the Vintage Method, Staff concedes that its recommendation is not the Vintage Method as recommended by NARUC.[97] Rather, Staff's "modified" Vintage Method is a creation of Staff that seeks to use the whole group depreciation rates set by Staff more than 10 years ago and use these rates for the "modified" method proffered by Staff.[98] Staff argues that the Commission has the plenary authority to require any method it deems appropriate.[99] Although this may be the case, it is surprising that Staff would recommend an approach that is nowhere to be found in NARUC guidance for how to implement depreciation methods, including the Vintage Method.[100] It is especially surprising when the Commission's own rules incorporate the NARUC Uniform System of Accounts.[101] One would expect the Commission to also look to NARUC for how to properly implement any new

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[95] *Id.* The Company inadvertently used $46,000 for this amount. Staff and RUCO are correct that the amount should be $49,813, which is the three-year average referenced in the amended refinancing application.
[96] Based on comments in Staff's Opening Brief, the Company has re-examined its depreciation expense calculations. The Company has determined that it inadvertently failed to reflect the depreciation adjustment on the post- test year plant adjustment and inadvertently overstated the roll forward correction. When these changes are made, the Company's revised depreciation expense is $1,706,829, which is only $21,889 different than Staff's expense, much of which is a result of the 24-month deferral recommendation/rejection by Staff. A revised Schedule C-2 is attached as Exhibit A to this brief to account for these revisions.
[97] Ex. A-32 at 176-180; Tr. at 954; Staff's Opening Brief at 10-11.
[98] Ex. A-34; Ex. S-6 at Ex. KS at 12-13.
[99] Staff's Opening Brief at 10.
[100] Tr. at 954; Ex. A-32.
[101] A.A.C. R14-2-411.D.2.

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depreciation methodology. Although Staff claims that its approach is "systematic and rational," the evidence does not support such a claim. What the evidence does support is that Staff had not analyzed many of the issues that a regulator must analyze in determining an appropriate depreciation methodology. Staff did not look at its required depreciation rates to determine if they worked with its "modified" Vintage method. Staff also failed to analyze whether the costs of implementing such a system would outweigh the perceived benefits. As customers would most likely pay for such costs, this analysis cannot be ignored.

What is clear when NARUC's guidance is reviewed is that the very issues Staff is trying to remedy with its recommendation would continue to exist if the Vintage Method were appropriately applied.[102] Staff's and RUCO's recommendation is a solution looking for a problem. As such, rather than require a costly and time consuming change to depreciation methodology, a more appropriate approach would be to revise depreciation rates to more properly reflect the service lives of the group of assets for which Staff has taken issue.[103] In fact, in the *New River* matter, which Staff and RUCO cite as support for this change in methodology, Staff itself recognized during that proceeding that a change in depreciation rates could remedy its concerns.[104]

Unlike the *New River* matter, there is no claim in this case that CCWC improperly depreciated accounts.[105] In fact, both Staff and RUCO concede that CCWC followed the requirements of its prior rate case decision in relation to depreciation.[106] There is also no claim that CCWC failed to make proper retirements, and once again both Staff and RUCO concede that this new approach to depreciation is not being driven by improper retirements as was the case in the *New River* matter and other Commission dockets.[107]

[102] Ex. A-32 at 43, 195 (confirming depreciation accrues until plant is retired).
[103] Company's Schedules at Sch. C-2; Tr. at 853-54.
[104] Decision No. 74294 at 15.
[105] Staff's Opening Brief at 11.
[106] Tr. at 932-34; 643-44.
[107] *Id.*; *see, e.g.,* Decision No. 74294 at 18.

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According to Staff (and ultimately RUCO), certain accounts are "over depreciated", and as such, adjustments must be made.[108] And, rather than adjust depreciation rates for the two accounts at issue, Staff (and ultimately RUCO) has recommended a completely new depreciation methodology that is not supported by NARUC, but is rather the creation of Staff.[109] As set forth in its Final Schedules and as Ms. Hubbard testified at the hearing, CCWC proposes a revision to the depreciation rates for Accounts 311000 (Pumping) and 341100 (Transportation). This would address any concerns raised by Staff and would avoid a wholesale, unnecessary, and costly change to the Company's (and its affiliates') depreciation methodology.[110] In its Final Schedules, the Company adopted a revised depreciation rate of 8% (12.5 years) for the pumping account and a revised depreciation rate of 10% (10 years) for the transportation equipment account.[111] Even though Staff continues to recommend its "modified" Vintage Method, Staff admitted at the hearing that the depreciation rate revisions would accomplish the same objective:

> If you have evidence of over-recovery, it would suggest that the rate is probably too high. You know, Staff's position is Staff's position. Our first choice is just to exclude it. Okay? Lowering the rate on the overall amount effectively does the same thing, more or less.[112]

Given the amount of uncertainty about the approach recommended by Staff and now RUCO and its implementation, and given that a revision to the depreciation rate would accomplish the same result, CCWC strongly urges the Commission to adopt a revision to the depreciation rates. If the Commission finds that there may be value in a change to the methodology, this should only be adopted with additional, extensive analysis and input from all interested and affected parties.

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[108] RUCO's Schedules; Staff Schedules; Ex. S-11 at 6-11.

[109] Tr. at 930 ("I based it on conversations I had with other Staff members as to how it had been proposed and/or adopted in other cases.").

[110] Tr. at 853-54; Company's Schedules at Sch. C-2.

[111] Company's Schedules at Sch. C-2.

[112] Tr. at 950.

2. Tank Maintenance

CCWC conservatively proposed an eighteen-year tank maintenance plan "to ensure that maintenance occurs at a frequency that balances the timing necessary to effectively extend the life of these assets through maintenance activities and in a manner that is not overly burdensome to customers."[113] As explained during the hearing, it would be reasonable to conduct this maintenance at a more rapid pace, thus increasing the annual cost, but the Company believes that its proposed approach strikes the right balance of timing and cost.[114] Staff, consistent with the approach approved by the Commission in prior cases, recommends the approval of this plan and the inclusion of the requested amounts as an expense item.[115]

RUCO continues to misstate the Commission's prior actions in relation to tank maintenance. Although RUCO continues to argue that the Commission rejected a similar plan in a prior case, RUCO's claim is incorrect.[116] A reading of that decision makes clear that the Commission rejected a tank maintenance reserve account proposed by the company and instead approved the inclusion of tank maintenance expense, as is the case here.[117] The approach approved in prior Commission decisions has proven to be an effective means to address the tank maintenance issues in those districts.[118] Indeed, there is no evidence or argument to the contrary in this case. The condition of the tanks in the CCWC service territory is very similar to the condition of the tanks in the Sun City Water District, and the maintenance program being proposed here will bring the same "long term system benefits" that the Commission cited for the Sun City Water District.[119]

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[113] Ex. A-18 at 6.
[114] Tr. at 479-80.
[115] Staff's Schedules.
[116] RUCO's Opening Brief at 13.
[117] Decision No. 71410 at 37.
[118] Ex. A-20 at 3.
[119] Decision No. 72047 at 58.

3. Incentive Compensation; Corporate Allocation

Both Staff and RUCO propose a decrease to corporate allocation expense relating to incentive compensation.[120] It cannot be disputed that incentive compensation is an important component of salary and wages. However, Staff and RUCO continue to argue that this compensation should not be included because it benefits both shareholders and customers.[121] What continues to be missing in their analysis, however, is that safe, efficient and effective employees will always benefit both shareholders and ratepayers.[122] Incentive compensation is just another way to compensate employees and should not be treated any differently than any other labor expense.

Staff appears primarily concerned with the 10% of the incentive compensation that is based on financial performance.[123] As Ms. Hubbard explained, this component benefits consumers in the long run, while at the same time recognizing that the utility benefits from increased net earnings in the short term.[124] The remaining 90% of the incentive compensation is based on specific activities of the individual business units (departments).[125] The intention of designating a portion of the employees' compensation at risk subject to performance targets is to drive performance to engage and focus all employees on improving the business unit's performance as a service provider.[126]

Incentive compensation, just like salaries and wages, is part of an employee's compensation package and should be treated as a cost of service.[127] Through the use of this type of compensation, EPCOR is able to motivate employees to deliver results in line with the company's culture, which stresses the importance of working safely and

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[120] Staff's Opening Brief at 7-8; RUCO's Opening Brief at 10-11.
[121] Staff's Opening Brief at 7-8; RUCO's Opening Brief at 10-11.
[122] Ex. A-6 at 23.
[123] Staff's Opening Brief at 7-8.
[124] Ex. A-6. at 23-24.
[125] *Id.* at 24.
[126] *Id.*
[127] *Id. at 24.*

responsibly and delivering quality customer service.[128] All of these metrics work together to provide benefits to customers.[129] Ultimately, these amounts are no different than a labor expense and should be treated in the same manner.[130]

4. Declining Usage

As Staff explained in its Opening Brief, Staff "reviewed data provided by the Company which showed that consumption patterns had continued to change during the post-test year period."[131] As this data evidences a "known and measurable change," Staff correctly reasoned that this adjustment was appropriate.[132] Although CCWC did a different analysis than Staff, both approaches result in the same determination—usage is declining and an adjustment is appropriate. CCWC, as recommended by RUCO, is willing to provide an annual filing by March 30th of each year to show actual usage in the residential class.[133] Based on trends in usage, CCWC expects that these compliance filings will continue to demonstrate declining usage, further supporting the Company's request.

RUCO cites to annual data in an attempt to show that usage is not declining. However, RUCO did not perform a rolling average analysis as performed by the Company. Furthermore, although RUCO cites to the Company's data from 2013, it fails to note that this data does in fact show a decline (as noted by Staff).[134] For these reasons, the Company's request should be adopted.

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[128] *Id.* at 23-24; Tr. at 114-18.
[129] Ex. A-7 at 7.
[130] *Id.* RUCO also recommends a 50% disallowance at the CCWC level. For the same reasons, discussed here, that adjustment should also be rejected.
[131] Staff's Opening Brief at 15.
[132] *Id.*
[133] Ex. A-6 at 22.
[134] RUCO's Opening Brief at 9.

5. Water Loss

CCWC continues to strongly believe that water loss is an issue that must be addressed.[135] However, as the new owner of the system, EPCOR should be given the opportunity to address water loss before a punitive reduction in certain expenses is imposed.[136] CCWC's request is that the Commission, as a compliance requirement, allow CCWC to file a plan to continue to reduce water loss as the Commission has ordered in many other matters.[137] This same approach was approved by the Commission in a recent decision in which the utility's water loss was at 19 percent.[138] EPCOR has demonstrated since taking ownership of CCWC that its approach to water loss is working and requests that it be allowed to continue to implement these plans without the need for the adjustment to power, water, and chemical expenses proposed by Staff.[139]

6. Property Tax Expense

The parties continue to dispute the appropriate assessment ratio for purposes of determining property tax expense. Although focus has been put on the correct assessment ratio, Staff and RUCO fail to address that the appropriate analysis is on the total amount of the tax, not the ratio. Staff has averaged the assessment rates for 2014 through 2016 to reach a rate of 18.5%.[140] RUCO, as part of its initial testimony, used the 2014 rate of 19%.[141] However, in its surrebuttal testimony, RUCO adopted Staff's three-year average of 18.5%.[142] The Company has continued to rely upon the 2014 assessment ratio of 19.0%.[143] The basis for doing so is that, despite the declining rates for the property tax assessment component, property taxes as a whole continue to rise as the

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[135] Ex. A-19 at 2-4.
[136] *Id.* at 4. As Mr. Stuck explained in his testimony, there is no correlation between water loss and increased power expense. Tr. at 480-81. As such, it is not appropriate to use that component of the adjustment.
[137] Ex. A-19 at 4.
[138] Decision No. 74440 at 20 (Apr. 18, 2014) (Cerbat Water Company).
[139] Ex. A-19 at 3-4.
[140] Staff's Schedules at GWB-18.
[141] Ex. R-13 at 39-40.
[142] Ex. R-14 at 26.
[143] Ex. A-30 at 4-5.

ratio is only one factor in determining the amount ultimately assessed.[144] For example, as property values rise, property taxes will increase. Thus, it is appropriate to use the ratio that will be in effect at the time that CCWC's rates go into effect (*i.e.*, 2014) to set an appropriate property tax expense in this case.[145]

7. Income Tax Expense

Although the parties agree on the tax rate for income tax expense, there continues to be a dispute as to the amount, given the hypothetical capital structure recommendation.[146] Once again, both Staff and RUCO rely upon the hypothetical capital structure and the resulting overstatement of interest expense which leads to a recommendation of a hypothetical income tax expense.[147] There is no dispute that CCWC will pay its actual income taxes, based on the deduction of its actual interest expense, not its hypothetical income taxes determined using a hypothetical interest deduction.[148] Accordingly, it is not sensible to rely upon the hypothetical income tax expense and the adjustments made by Staff and RUCO should be rejected.

F. Other Items in Dispute

1. CAP Surcharge

With its Purchased CAP Water Surcharge, CCWC is seeking to address changes in CAP related expenses as described in its plan of administration in the same manner that it has done for years in districts operated by its affiliate.[149] Each year, CAWCD re-examines the price for CAP water and those changes are significant, known and measurable.[150] The use of this surcharge will allow for the exact recovery of this known and essential expense, and, when faced with CAP water price increases, will allow for a

[144] Tr. at 180.
[145] Ex. A-30 at 4-5; Tr. at 180.
[146] Tr. at 824-825.
[147] *Id.*
[148] *Id.* at 825.
[149] Ex. A-25 at 9-15. At the request of Staff, the Company agreed at the hearing to change the name of its Sustainable Water Surcharge. Tr. at 538-39.
[150] Ex. A-25 at 9-12.

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healthier utility.[151] Also, the surcharge, as proposed by CCWC, will incorporate changes in growth as part of its calculation in the same manner as has been done in these other districts.[152]

CAWCD has been faced with rapidly increasing costs and shortfalls in revenue.[153] It is well known that CAWCD faces many issues which could lead to substantial increases in the cost of CAP water.[154] These issues are exactly why this surcharge should be approved so that CCWC will receive full recovery of such a vital expense each year after the expense has occurred.[155] Just as purchased power is critical to the electric industry (and thus subject to a surcharge), purchased water is critical to the water industry.

RUCO recommends the denial of this surcharge and the use of an erroneously created average CAP water price to arrive at its recommended purchased water expense.[156] Although both Staff and CCWC agree that the adjusted test year purchased water expense should be expensed, both also recognize that the proposed mechanism will be used to pass through increases or decreases in costs above or below the adjusted purchased water expense, which is reflective of purchased CAP water.[157] If RUCO's projection is correct, then there will be no issue and no surcharge or a very minimal surcharge will be implemented. However, given uncertainties in the cost of this vital resource, it is unlikely that the projections will match the actual expenditures. For all of these reasons, the Commission should approve the Company's Purchased CAP Water Surcharge.[158]

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[151] *Id.* at 13.
[152] Tr. at 529.
[153] Ex. A-25 at 14.
[154] *Id.*
[155] *Id.*
[156] Ex. A-26 at 5.
[157] *Id.*
[158] In its pre-filed testimony and during the hearing, RUCO recommended the implementation of a rate case expense surcharge if a CAP surcharge is approved. RUCO did not provide any details regarding the specifics of this proposal during the hearing. In its Opening Brief, however, RUCO has argued separately for the implementation of

2. **SIB Mechanism**

RUCO continues to make the same arguments in relation to the SIB mechanism that the Commission has rejected in each matter that has come before it. Recently, the Commission again rejected RUCO's arguments in two Commission decisions.[159] In both decisions, the Commission thoroughly addressed the legal arguments made by RUCO in relation to the SIB in this case.[160]

In addition to its legal arguments, RUCO claims, without merit, that a SIB is not needed for CCWC.[161] RUCO bases this claim on an excerpt from the Company's testimony at the hearing. When asked if the Company could wait until the next rate case to recover the plant investment made for the SIB-eligible plant, the Company's engineer indicated, quite correctly, that it could.[162] If required by the Commission to wait, the Company could do so as it has always done. CCWC will maintain its system as it has always done. CCWC, however, will also continue to underearn as it has always done and will be back before the Commission with more frequent and larger rate cases.

It is uncontroverted that CCWC, especially under EPCOR's ownership, has continued to maintain its system to provide safe and reliable drinking water. It is also uncontroverted that the system is in need of additional repairs, including repairs and replacements for SIB-eligible plant. Despite the implications to the contrary by RUCO, CCWC has been extremely diligent in its efforts to support its SIB request.[163] Similarly, Staff has reviewed the information submitted by the Company in great detail, as evidenced by the multiple revisions to certain SIB information as required by Staff. Based on its extensive review, Staff has concluded that CCWC has met the criteria first

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the rate case expense surcharge (i.e., not tied to the CAP surcharge) and has provided specific calculations outside of the hearing. The Company continues to oppose this surcharge as noted during the hearing.

[159] Decision No. 74463 (Arizona Water); Decision No. 74437 (LPSCO).

[160] *Id.*

[161] RUCO's Opening Brief at 2.

[162] Tr. at 498-99.

[163] Ex. A-22; Ex A-23; Ex. S-6 at 15.

set forth in the settlement agreement in the *Arizona Water Company (Eastern District)* matter and applied in multiple cases since that time.[164]

CCWC's testimony makes clear that CCWC is willing to abide by the Commission's requirements for the SIB mechanism and that it has the technical expertise and commitment to submit the required information as part of its future SIB filings.[165] As recommended by Staff, CCWC is also willing to file its Plan of Administration as a compliance item in this case within 30 days of a decision and will conform that Plan of Administration to the form recommended by Staff and agreed to by CCWC.[166]

Despite the overwhelming evidence in support of the SIB mechanism in this case, RUCO has continued to proffer its rejected legal arguments in opposition to the SIB.[167] The Commission again rejected these arguments in its most recent decisions, including the rehearing of the *Arizona Water Company (Eastern District)* case. CCWC agrees with the legal conclusions made in those matters. As those decisions have made clear, the SIB mechanism complies with the constitutional requirements by which the Commission is bound. Similarly, it is appropriate to approve the Company's request for a SIB mechanism in this case.

3. Rate Design

CCWC continues to oppose the rate design recommended by Staff, which includes a large discount on the first tier.[168] By reducing this first tier below that of the current first tier rate, customers receive inappropriate pricing signals, *i.e.*, that water is

[164] Ex. S-6 at 15. RUCO argues that CCWC should have submitted a POA rather than agree to adopt the form of POA proposed by Staff. This is a distinction without a difference. CCWC has agreed to comply with the POA required by Staff. RUCO also makes an issue of the fact that the POA did not include revenue numbers as was the case in the *Arizona Water* and *LPSCO* matters. Unlike those matters, there is not an approved revenue requirement in this case (as in the *Arizona Water* case) nor a settlement agreement with an agreed revenue requirement (as in the *LPSCO* case).

[165] Ex. A-21 at 3.

[166] Ex. A-7 at 13; Tr. at 511-13.

[167] Ex. R-13 at 46; Tr. at 602-03.

[168] Company's Schedules (H Schedules); Ex. A-6 at 30.

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less expensive than before, which is not the case.[169] Although Staff argues in its Opening Brief that there should be a discount on "non-discretionary usage" in the first tier, there is no doubt that the cost of providing water service is increasing.[170] These increasing costs should be reflected in customers' rates.

In addition, these tiered rates, as proposed by Staff, make it extremely difficult, if not impossible, for CCWC to achieve its authorized revenue requirement.[171] Once again, the Company urges the Commission to heed the analysis provided by Mr. Bourassa, who performed the Company's cost of service study:

> Water/wastewater utilities are very capital intensive. Most of the costs that you look at in a cost of service study are what I will call fixed costs. They are there regardless of the amount of water that is sold. And typically in rate designs that have been adopted by the Commission, some portion of the fixed cost is actually recovered through the commodity rates. And you don't get commodity revenues unless you sell water. So if there is any risk to, or if there is a risk to selling all the water you need to cover your costs, then you are going to have that risk of underrecovery.
>
> And it is exacerbated by the fact that we use inverted tier rates. Why? Because we actually --inverted tier rates means that we have a low cost rate at the front end and a higher cost rate as more water is used. And what typically happens then is that more of the cost recovery is up in the higher usage blocks, but that's a design that encourages conservation. So if you actually experience conservation, you are not going to recover all of your cost of service.
>
> ****
>
> One example of what I mean is if you look at --actually, let's look at Exhibit A-2, Schedule G-9, page 1. This schedule reflects a breakeven analysis based on the rate design that the company proposes. You will see that the breakeven point isn't until somewhere between 8- and 9,000 gallons of water usage. So by the first tier, which is the lowest commodity rates, we are selling water well below its true cost, to the tune of, this schedule shows which is my rebuttal schedule, $12.26. So that's what I mean by there is substantial risk in rate design, because we are not even reaching a breakeven point until that 8- or 9,000-gallon breakeven point. And I don't believe that our average usage --our average usage is, for the residential meter, is right at 8,000 gallons. So conservation, if we lower that average down, we are not even reaching our breakeven point.[172]

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[169] Ex. A-6 at 30.
[170] Staff's Opening Brief at 23.
[171] Ex. A-6 at 30.
[172] Tr. at 547-49.

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As noted by the Company in its Opening Brief, in two recent decisions, the Commission recognized issues with these rate designs and the risk of under-recovery.[173] In both of those cases, the Commission revised Staff's recommended rate design by increasing the fixed charge.[174] The same issues that the Commission recognized in those cases exist in this case but on a larger scale. Accordingly, the Company requests that the Commission adopt the Company's rate design.

4. Miscellaneous Service Charges

CCWC's miscellaneous service charges for items such as after-hours and regular-hours establishment of service should be directly related to the costs to provide such services.[175] Staff recommends rejecting the Company's proposed charges and instead relies upon lesser rates for these services that are not tied to actual costs.[176] The Company continues to recommend the adoption of its proposed fees and believes that charging the actual costs for these services is appropriate as it allows the Company to recover those costs and sends appropriate price signals to customers.[177] Staff argues that the Company did not provide sufficient support for these changes. However, Staff appears to ignore the sworn testimony of Company witnesses that these amounts reflect actual costs.[178] Staff did not provide any evidence to the contrary and Staff's arguments should be rejected.

5. Low Income Program

The Company has proposed a Low Income Program as part of this Application. As reflected in its Final Schedules, the Company has included a $7.50 discount for up to 250 customers at a total cost of $22,500.[179] Staff also supports this level of discount as

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[173] Decision No. 74391 at 11; Decision No. 74398 at 17-18.
[174] Decision No. 74391 at 11; Decision No. 74398 at 17-18.
[175] Ex. A-6 at 28.
[176] Staff's Schedules.
[177] Ex. A-6 at 28.
[178] Ex. A-6 at 28-29.
[179] Company's Schedules at Sch. H-2.

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part of its filings. However, neither Staff nor RUCO has included any mechanism by which these costs will be recovered.[180]

As reflected in the Company's H-2 Schedule, the Company has requested to spread this cost over the highest block consumption of Residential and Commercial customers, which totaled 392,580 kgals resulting in a surcharge on the highest block for those customers of $0.0573 per kgal ($22,500 / 392580 kgals).[181] This same approach has been used in other EPCOR districts in which a low income program has been implemented, and the Company requests that it be implemented here as well.

RESPECTFULLY SUBMITTED this 25th day of April, 2014.

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[180] Staff's Schedules; RUCO's Schedules.
[181] *Id.*

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EXHIBIT A

Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement Pro Forma Adjustments

Exhibit
Schedule C-2 FINAL
Page 1
Witness: Murrey

Line No.		[A] Test Year Adjusted Rebuttal Results	[B] FINAL ADJ SLH-1 Annualize Property Taxes	[C] FINAL ADJ SLH-2 Federal and State Income Taxes	[AA] FINAL ADJ SLH-3 Depreciation Exp. Adj due to Plant & AD Roll-forward	[AB] FINAL ADJ SLH-4 Interest Synchronization	[AC] FINAL ADJ SLH-5 Remove Audit Fees	[AD] FINAL ADJ SLH-6 Revise Depreciable Lives on Acct 311000 and 341100	[AE] Total Pro Forma Adjustments	[AF] Test Year Adjusted Rejoinder Results	[AG] Proposed Rate Increase	[AH] Adjusted with Rate Increase
					COMPANY FINAL-Revosed							
1	**Revenues**											
2	Water Revenues	$ 8,915,656							$ -	$ 8,915,656	$ 2,712,490	$ 11,628,146
3	Other Revenues	99,329							-	99,329		99,329
4												-
5		$ 9,014,985	$ -	$ -	$ -	$ -	$ -		$ -	$ 9,014,985	$ 2,712,490	$ 11,727,475
6	**Operating Expenses**											
7	Labor	$ 1,024,112							$ -	$ 1,024,112		$ 1,024,112
8	Purchased Water	1,156,477							-	1,156,477		1,156,477
9	Fuel & Power	605,885							-	605,885		605,885
10	Chemicals	119,266							-	119,266		119,266
11	Waste Disposal	7,113							-	7,113		7,113
12	Intercompany Support Services	94,150							-	94,150		94,150
13	Corporate Allocation	442,409							-	442,409		442,409
14	Outside Services	508,106					(49,813)		(49,813)	458,293		458,293
15	Group Insurance	178,067							-	178,067		178,067
16	Pensions	85,086							-	85,086		85,086
17	Regulatory Expense	91,668							-	91,668		91,668
18	Insurance Other Than Group	73,025							-	73,025		73,025
19	Customer Accounting	318,959							-	318,959	24,227	343,185
20	Rents	1,504							-	1,504		1,504
21	General Office Expense	164,179							-	164,179		164,179
22	Miscellaneous	158,553							-	158,553		158,553
23	Maintenance Expense	388,614							-	388,614		388,614
24	Depreciation & Amortization	2,020,850			(84,544)			(229,477)	(314,021)	1,706,829		1,706,829
25	General Taxes-Property	238,486	82,560						82,560	321,046	31,914	352,960
26	General Taxes-Other	86,320							-	86,320		86,320
27	Income Taxes	390,135		120,705					120,705	510,840	1,017,116	1,527,956
28												
29	**Total Operating Expenses**	$ 8,152,965	$ 82,560	$ 120,705	$ (84,544)	$ -	$ (49,813)		$ (160,569)	$ 7,992,396	$ 1,073,257	$ 9,065,653
30	**Utility Operating Income**	$ 862,020	$ (82,560)	$ (120,705)	$ 84,544	$ -	$ 49,813		$ 160,569	$ 1,022,590	$ 1,639,233	$ 2,661,822
31	**Other Income & Deductions**											
32	Other Income & Deductions	$ -							$ -	$ -		$ -
33	Interest Expense	233,260				(33,964)			(33,964)	199,295		199,295
34	Other Expense	-							-	-		-
35	Gain/Loss Sale of Fixed Assets	-							-	-		-
36	**Total Other Income & Deductions**	$ (233,260)	$ -	$ -	$ -	$ 33,964	$ -		$ 33,964	$ (199,295)	$ -	$ (199,295)
37	**Net Profit (Loss)**	$ 628,760	$ (82,560)	$ (120,705)	$ 84,544	$ 33,964	$ 49,813		$ 194,534	$ 823,294	$ 1,639,233	$ 2,462,527
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43 Supporting Schedules:
44 E-6
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46 Workpapers & Supporting Documents:
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Recap Schedules:
C-1 Rejoinder

Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-1

Exhibit
Schedule C-2 FINAL-REVISED
Page 2
Witness: Murrey

Line No.		[A] Property Tax Expense	[B] Property Tax Expense For Conversion Factor
1			
2			
3	Adjust Property Taxes to Reflect Proposed Revenues:		
4			
5	Adjusted Revenues in Year Ended June 2010	$ 9,014,985	$ 9,014,985
6	Adjusted Revenues in Year Ended June 2010	9,014,985	9,014,985
7	Proposed Revenues	9,014,985	11,727,475
8	Average of Three Year's of Revenue	$ 9,014,985	$ 9,919,149
9	Average of Three Year's of Revenue, times 2	$18,029,971	$19,838,297
10	Add:		
11	Construction Work in Progress at 10%	161,294	161,294
12	Deduct:		
13	Net Book Value of Transportation Equipment	$ -	$ -
14			
15	Full Cash Value	$ 18,191,265	$ 19,999,591
16	Assessment Ratio (For 2011 per HB 2784)	19%	19%
17	Assessed Value	$ 3,456,340	$ 3,799,922
18	Property Tax Rate	9.29%	9.29%
19			
20	Property Tax	321,046	352,960
21	Tax on Parcels	-	-
22			
23	Adjusted Test Year Property Taxes at Present Rates (Line 18+Line 19, Col [A])	$ 321,046	
24	Adjusted Test Year Property Taxes	238,486	
25	Adjustment to Revenue and/or Expense (To Sch C-2, Col [AA])	$ 82,560	
26			
27	Adjusted Test Year Property Taxes at Proposed Rates (Line 18+Line 19, Col [B])		$ 352,960
28	Adjusted Test Year Property Taxes at Present Rates (Line 21, Col [A])		321,046
29	Additional Property Taxes on Proposed Revenues (To Sch C-2, Col [AH])		$ 31,914
30			
31			
32			
33	CALCULATION OF PROPERTY TAX FACTOR TO COMPUTE GROSS REVENUE CONVERSION FACTOR (SCH C-3):		
34			
35	Increase in Property Tax Due to Increase in Revenue Requirement (Line 27, Col [B])		$ 31,914
36			
37	Increase in Revenue Requirement (From Sch. A1)		$ 2,712,490
38			
39	Increase in Property Tax Per Dollar Increase in Revenue (Line 33/Line 35)		1.18%
40			
41			
42			
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47	Workpapers & Supporting Documents:		
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Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-2

Exhibit
Schedule C-2 FINAL-REVISED
Page 3
Witness: Murrey

Line No.			Test Year Adjusted Results	Adjusted with Rate Increase
1				
2				
3	Calculation of Income Taxes at Proposed Rates			
4				
5				
6	Operating Income Before Inc. Taxes		$ 1,533,429	$ 4,189,778
7	Interest Expense		199,295	199,295
8	Arizona Taxable Income		$ 1,334,134	$ 3,990,483
9				
10	Less Arizona Income Tax		$ 86,719	$ 259,381
11	Arizona Income Tax Rate =	6.500%		
12				
13	Federal Income Before Taxes		$ 1,334,134	$ 3,990,483
14	Less Arizona Income Taxes		86,719	259,381
15	Federal Taxable Income		$ 1,247,415	$ 3,731,101
23				
24	Federal Income Taxes	34.000%	$ 424,121	$ 1,268,574
25				
26				
27	Total Income Tax		$ 510,840	$ 1,527,956
28				
29	Tax Rate		38.29%	38.29%
30				
31	Effective Income Tax Rates			
32	State		6.500%	6.500%
33	Federal		31.79%	31.79%
34				
35				
36	Test Year Income Taxes, Per Books		$ 390,135	
37	Increase in Income Taxes		$ 120,705	
38				
39	Adjustment to Revenues and/or Expense		$ 120,705	
40				
41	Test Year Income Taxes, Adjusted			$ 510,840
42	Increase in Income Taxes			1,017,116
43				
44	Adjustment to Revenue and/or Expense			$ 1,017,116
45				
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47	Workpapers & Supporting Documents:			
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Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-3 (Page 1 of 4)

Exhibit
Schedule C-2 FINAL-REVISED
Page 4
Witness: Hubbard

Line No.	NARUC Account	Description	Annual Depr. Rate	Monthly Depr. Rate	From FINAL ADJ SLH-3 (Page 4 of 4): Plant Balance at 12/31/12 Plus PTYPA	From FINAL ADJ SLH-3 (Page 4 of 4): Annual Depreciation Expense		FINAL ADJ SLH-6: Revised Lives for Acct 311000 to 12.5 years (8%) and Acct 341100	FINAL ADJ SLH-6: Reduction in Depreciation Expense
1	Calculation of Depreciation Expense								
6	303100	Other Intangible Plant	0.00%	0.00%	$ -	$ -			
7	303600	Land and Land Rights	0.00%	0.00%	1,554,591	-			
8	304200	Structures and Improvements - Pumping	3.33%	0.28%	-	-			
9	304300	Structures and Improvements - Treatment	3.33%	0.28%	-	-			
10	304400	Structures and Improvements - T & D	3.33%	0.28%	-	-			
11	304500	Structures & Improvements - General	3.33%	0.28%	1,963,919	65,399			
12	305000	Collecting and Impounding Reservoirs	2.50%	0.21%	6,970	174			
13	307000	Wells	3.33%	0.28%	1,237,094	41,195			
14	309000	Supply Mains	2.00%	0.17%	-	-			
15	311000	Pumping Equipment & Other Pumping Plant	12.50%	1.04%	4,150,661	518,833		332,053	(186,780)
16	320100	Water Treatment Equipment	3.33%	0.28%	6,615,237	220,287			
17	330000	Reservoirs and Tanks	2.22%	0.19%	8,869,561	196,904			
18	331001	Transmission and Distribution Mains	2.00%	0.17%	25,566,351	511,327			
19	333000	Services	3.33%	0.28%	11,479,113	382,254			
20	334100	Meters & Meter Installation	8.33%	0.69%	3,038,174	253,080			
21	335000	Hydrants	2.00%	0.17%	2,095,035	41,901			
22	339100	Other Plant and Misc. Equipment	6.67%	0.56%	2,119,843	141,394			
23	340100	Office Furniture and Equipment, Computers	6.67%	0.56%	305,068	20,348			
24	341100	Transportation Equipment	20.00%	1.67%	426,970	85,394		42,697	(42,697)
25	343000	Tools, Shop and Garage Equipment	5.00%	0.42%	411,607	20,580			
26	345000	Power Operated Equipment	5.00%	0.42%	-	-			
27	346200	Communication Equipment	10.00%	0.83%	-	-			
28	347000	Other General Plant	10.00%	0.83%	257,095	25,710			
29		Total			$ 70,097,289	$ 2,524,780	(To page 5)		(229,477)
30									
31		Less: Non-Depreciable Plant (L6 & L7)			$ 1,554,591				
32									
33		Depreciable Plant (L30 - L32)			$ 68,542,698				
34									
35		Composite Depreciation Rate			3.68%	(To page 5)			

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45 Workpapers & Supporting Documents:
46 Schedule E-5
47 Approved in Dec No. 71410 Dec 2009
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Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-3 (Page 2 of 4)

Exhibit
Schedule C-2 FINAL-REVISED
Page 5
Witness: Hubbard

Line No.	Description			
1				
2	Adjust Depreciation/Amortization Expense to Reflect Test Year Adjusted Plant:			
3				
4	Annualized Depreciation Expense on Test Year UPIS		$ 2,524,780	(From page 4)
5	Annualized Deferred CAP Amortization		$ 15,641	
6	Annualized Amortization of 24-Month Deferral		$ 23,586	
7	Annualized Amortization of Gain on FHSD Settlement		$ (76,000)	(From page 6)
8				
9				
10	Total Annualized Depreciation and Amortization		$ 2,488,007	
11				
12				
13				
14				
15				
16				
17				
18	Less: Amortization of Contributions			
19	Contributions at TYE 12/31/12	$ (15,167,681)		
20	Rate Base Adjustment (SLH-4) removing CIAC not in Plant in Service at 12/31/12	175,810		
21	Adjusted Contributions at TYE 12/31/12	$ (14,991,871)		
22				
23	Composite Depreciation Rate for District	3.68%		(From page 4)
24	Amortization of CIAC (Ln21 X Ln23)		$ (551,701)	
25				
26	Total Depreciation Expense less Amortization of Contributions		$ 1,936,306	
27				
28	Adjusted Test Year Depreciation and Amortization Expense		$ 2,020,850	(Total incl Depr on PTYPA)
29				
30	Increase/(Decrease) in Depreciation and Amortization Expense		$ (84,544)	
31				
32	Rebuttal Adjustment to Revenue and/or Expense		$ (84,544)	
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Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-3 (Page 3 of 4)

Exhibit
Schedule C-2 FINAL
Page 6
Witness: Hubbard

Line No.	Description		Amount	
2	Adjust Depreciation/Amortization Expense to Reflect Commission-ordered Sharing of Settlement with Fountain Hills			
3	Sanitation District			
5	In Decision No. 72258, issued April 7, 2011, the Commission ordered Chaparral City Water Company to share proceeds			
6	received in settlement of a Well Transfer Agreement between the Company and the Fountain Hills Sanitation District.			
9	Settlement Proceeds from Well Transfer Agreement	$	1,520,000	
11	Percentage of Proceeds to be Shared with Customers		50.0%	
13	Settlement Proceeds Allocated to Customers	$	760,000	
15	Authorized Amortization Period in Years		10	
17	Annual Amortization of Settlement Proceeds	$	76,000	
21	Allocated Settlement Proceeds	$	(76,000)	(To page 5)
46	Workpapers & Supporting Documents:			
50	\2013 Chaparral Water Sch. A-F Rebuttal.xls			

Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-3 (Page 4 of 4)

Line No.	NARUC Account	Description	Plant in Service: Plant Balance at 12/31/2012	Plant in Service: Post Test Year Plant Additions	Plant in Service: Total Plant	Accumulated Depreciation: Accumulated Depreciation at 12/31/2012	Accumulated Depreciation: Depreciation for Post Test Year Plant Additions	Accumulated Depreciation: Total Accumulated Depreciation	Annual Depr. Rate	Depreciation Expense: Annual Dep Expense for Plant in Service	Depreciation Expense: Annual Dep Expense for Post TY Additions	Depreciation Expense: Total Annual Depreciation
1												
2												
3												
4												
5												
6												
7	303100	Other Intangible Plant	$ -		$ -		$ -	$ -	0.00%	$ -	$ -	$ -
8	303600	Land and Land Rights	1,554,591	-	1,554,591	0	-	-	0.00%	-	-	-
9	304200	Structures and Improvements - Pumping	-	-	-		-	-	3.33%	-	-	-
10	304300	Structures and Improvements - Treatment	-	-	-		-	-	3.33%	-	-	-
11	304400	Structures and Improvements - T & D	-	-	-		-	-	3.33%	-	-	-
12	304500	Structures & Improvements - General	1,795,309	168,610	1,963,919	694,767	2,807	697,574	3.33%	59,784	5,615	65,399
13	305000	Collecting and Impounding Reservoirs	6,970	-	6,970	660	-	660	2.50%	174	-	174
14	307000	Wells	159,627	1,077,467	1,237,094	108,329	17,940	126,269	3.33%	5,316	35,880	41,196
15	309000	Supply Mains	-	-	-		-	-	2.00%	-	-	-
16	311000	Pumping Equipment & Other Pumping Plant	4,150,661	-	4,150,661	3,502,552	-	3,502,552	12.50%	518,833	-	518,833
17	320100	Water Treatment Equipment	6,541,526	73,711	6,615,237	1,509,048	1,227	1,510,275	3.33%	217,833	2,455	220,288
18	330000	Reservoirs and Tanks	8,199,140	670,421	8,869,561	3,046,816	7,442	3,054,258	2.22%	182,021	14,883	196,904
19	331001	Transmission and Distribution Mains	24,374,049	1,192,302	25,566,351	9,606,641	11,923	9,618,564	2.00%	487,481	23,846	511,327
20	333000	Services	10,919,034	560,079	11,479,113	2,320,901	9,325	2,330,226	3.33%	363,604	18,651	382,255
21	334100	Meters & Meter Installation	2,919,624	118,550	3,038,174	2,374,387	4,938	2,379,325	8.33%	243,205	9,875	253,080
22	335000	Hydrants	2,040,005	55,030	2,095,035	389,993	550	390,543	2.00%	40,800	1,101	41,901
23	339100	Other Plant and Misc. Equipment	2,010,127	$ 109,716	$ 2,119,843	$ 946,813	3,659	950,472	6.67%	134,075	7,318	141,393
24	340100	Office Furniture and Equipment, Computers	305,068		305,068	152,716	-	152,716	6.67%	20,348	-	20,348
25	341100	Transportation Equipment	417,333	9,637	426,970	487,368	964	488,332	20.00%	83,467	1,927	85,394
26	343000	Tools, Shop and Garage Equipment	190,661	220,946	411,607	76,075	5,524	81,599	5.00%	9,533	11,047	20,580
27	344000	Laboratory Equipment				25	-	25	10.00%	-	-	
28	345000	Power Operated Equipment	-	-	-		-	-	5.00%	-	-	-
29	346200	Communication Equipment	43,327	213,768	257,095	26,668	10,688	37,356	10.00%	4,333	21,377	25,710
30	347000	Other General Plant	-	-	-	-	-	-	10.00%	-	-	-
31		Total	$ 65,627,052	$ 4,470,237	$ 70,097,289	$ 25,243,760	$ 76,987	$ 25,320,746		$ 2,370,807	$ 153,974	$ 2,524,781
32												
33		Rebuttal Rate Base ADJ SLH-3R and Income Statement ADJ SLH-2R	65,627,032	4,579,953	70,206,985	25,692,541	80,647	25,773,188		$ 2,475,016	$ 161,293	$ 2,636,309
34												
35		Adjustment to Rebuttal	$ 20	$ (109,716)	$ (109,696)	$ (448,781)	$ (3,660)	$ (452,442)		$ (104,209)	$ (7,319)	$ (111,528)
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47	Workpapers & Supporting Documents:											
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Chaparral City Water Company
Test Year Ended December 31, 2012
Income Statement FINAL Adjustment SLH-4

Exhibit
Schedule C-2 FINAL
Page 8
Witness: Murrey

Line No.			
1			
2			
3	Interest Synchronization with Rate Base		
4			
5	Original Cost Rate Base (Sch. B-1, Ln. 24)		$ 27,300,742
6	Weighted Cost of Debt from Schedule D-1		0.73%
7	Synchronized Interest Expense		$ 199,295
8			
9	Test Year Interest Expense	$ 233,260	
10			
11	Adjusted Test Year Interest Expense		$ 233,260
12			
13	Increase/(Decrease) in Interest Expense		$ (33,964)
14			
15	Adjustment to Revenue and/or Expense		$ (33,964)
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